

7535-01-U

NATIONAL CREDIT UNION ADMINISTRATION

12 CFR Part 701

Loan Interest Rates

AGENCY: National Credit Union Administration.

ACTION: Final Rule.

SUMMARY: The current 18 percent per year federal credit union maximum loan rate is scheduled to revert to 15 percent on March 9, 2005, unless otherwise provided by the NCUA Board (Board). A 15 percent ceiling would restrict certain categories of credit and adversely affect the financial condition of a number of federal credit unions. At the same time, prevailing market rates and economic conditions do not justify a rate higher than the current 18 percent ceiling. Accordingly, the Board hereby continues an 18 percent federal credit union loan rate ceiling for the period March 9, 2005 through September 8, 2006. The Board is prepared to reconsider the 18 percent ceiling at any time should changes in economic conditions warrant.

DATES: Effective February 28, 2005.

FOR FURTHER INFORMATION CONTACT: Daniel Gordon, Senior Investment Officer, Office of Strategic Program Support and Planning, at the National Credit Union Administration, 1775 Duke Street, Alexandria, Virginia 22314-3428, or telephone 703-518-6620.

SUPPLEMENTARY INFORMATION:

Background

Public Law 96-221, enacted in 1980, raised the loan interest rate ceiling for federal credit unions from one percent per month (12 percent per year) to 15 percent per year. 12 U.S.C. 1757(5)(A)(vi). The law also authorized the Board to set a higher limit, after consulting with Congress, the Department of Treasury and other federal financial agencies, for a period not to exceed 18 months, if the Board determined that: (1) money market interest rates have risen over the preceding six months; and (2) prevailing interest rate levels threaten the safety and soundness of individual credit unions as evidenced by adverse trends in growth, liquidity, capital, and earnings.

On December 3, 1980, the Board determined that the foregoing conditions had been met. Accordingly, the Board raised the loan ceiling to 21 percent. In the unstable environment of the first half of the 1980s, the Board lowered the loan rate ceiling from 21 percent to 18 percent, effective May 18, 1987. This action was taken in an

environment of falling market interest rates from 1980 to early 1987. The ceiling has remained at 18 percent to the present. The Board believes retaining the 18 percent ceiling will permit credit unions to continue to meet their current lending programs and permit the necessary flexibility for credit unions to react to any adverse economic developments.

The Board would prefer not to set loan interest rate ceilings for federal credit unions. Credit unions are cooperatives and establish loan and share rates consistent with the needs of their members and prevailing market interest rates. The Board supports free lending markets and the ability of federal credit union boards of directors to establish loan rates that reflect current market conditions and the interests of their members.

Congress, however, has imposed loan rate ceilings since 1934, and, as stated previously, in 1980, Congress set the ceiling at 15 percent but authorized the Board to set a ceiling in excess of 15 percent, if conditions warrant. The following analysis justifies a ceiling above 15 percent, but at the same time does not support a ceiling above the current 18 percent. The Board is prepared to reconsider this action at any time should changes in economic conditions warrant.

Money Market Interest Rates

As Table 1 below shows, interest rates on United States Treasury securities have increased in maturities of three years and less, in the six month period June 1, 2004 through November 30, 2004.

Table 1
Change in U.S. Government Yields
May 30, 2004 - November 30, 2004

| Maturity | Rate 5/30/2004 | Rate 11/30/2004 | Change |
|----------|-------------------|--------------------|--------|
| 3-month | 1.06% | 2.22% | 1.16% |
| 6-month | 1.38% | 2.43% | 1.05% |
| 2-year | 2.53% | 3.00% | .47% |
| 3-year | 3.06% | 3.25% | .19% |
| 5-year | 3.79% | 3.69% | -.10% |
| 10-year | 4.65% | 4.35% | -.30% |

In addition, between June 2004 and November 30, 2004, the Board of Governors of the Federal Reserve System raised the federal funds target rate four times, from 1.00 percent to 2.00 percent. In December 2004, the Federal Reserve raised the federal funds target rate another .25 percent. Statements from Federal Reserve officials indicate that further increases in the federal funds target rate are expected. For example, Anthony M. Santomero, President of the Federal Reserve Bank of

Philadelphia, said, “I think it is fair to say a neutral federal funds policy is above our current level.” Michael H. Moskow, President of the Federal Reserve Bank of Chicago, said, “There is certainly more ground to cover on interest rates.”

The forward Treasury curve (Table 2) also anticipates higher rates. The expected increases range from 87 basis points in the 1-year maturity to 34 basis points in the 10-year maturity.

Table 2

Implied 1-year Forward Rates- November 30, 2004

| Maturity | Change One-Year Forward Rate |
|----------|---------------------------------|
| 1-year | .87% |
| 2-year | .57% |
| 3-year | .52% |
| 5-year | .64% |
| 10-year | .34% |

Financial Implications for Credit Unions

For at least 450 federal credit unions, representing 7.79% percent of reporting federal credit unions, the most common rate on unsecured loans was above 15 percent at year-end 2003. While the bulk of credit union lending is below 15 percent, small credit unions and credit unions that have implemented risk-based lending programs require interest rates above 15 percent to maintain liquidity, capital, earnings, and growth. Loans to members who have not yet established credit histories or have weak credit histories have more credit risk. Credit unions must charge rates to cover the potential of higher than usual losses for such loans.

There are undoubtedly more than 450 federal credit unions charging over 15 percent for unsecured loans to such members. Many credit unions have “credit builder” or “credit rebuilder” loans but report only the most common unsecured loan rates on NCUA Call Reports. Lowering the interest rate ceiling for federal credit unions would discourage these credit unions from making certain loans and many of the affected members would have no alternative but to turn to other lenders who charge higher rates.

Small credit unions would be particularly affected by lower loan rate ceilings since they tend to have higher levels of unsecured loans, typically with lower loan balances. Table 3 shows the number of federal credit unions in each asset group where the most common rate is more than 15 percent for unsecured loans.

Table 3
Active Federal Credit Unions with Most Common
Unsecured Loan Rates Greater than 15 Percent
December 2003

| Peer Group by Asset Size | Total All Federal Credit Unions | Number of Federal Credit Unions with Greater than 15 Percent |
|--------------------------|---------------------------------|--|
| \$0-2 million | 1175 | 92 |
| \$2-10 million | 1794 | 164 |
| \$10-50 million | 1753 | 123 |
| \$50 million+ | 1051 | 71 |
| Total | 5773 | 450 |

Should the interest rate charged on loans be subject to a 15 percent ceiling, a number of federal credit unions, where the majority of members are low-income, will incur significant financial strain. Approximately 12.65 percent of federal credit unions with low-income designation report loan interest rates greater than 15 percent. In contrast, only 7.79 percent of all credit unions report rates above 15 percent. Approximately 14.33 percent of low-income credit unions with assets less than \$10 million would be affected.

These credit unions offset the cost of generating low-balance loans by charging increased interest rates. These credit unions generally are not able to provide credit card loans and, instead, grant closed-ended and open-ended loans with the prerequisite underwriting documentation. Further, these smaller credit unions generally maintain a higher expense ratio, since many are involved with high-transaction accounts requiring higher personnel costs and related operational expenses, and lack economies of scale.

Further, among the 450 federal credit unions where the most common rate is more than 15 percent for unsecured loans, 62 credit unions have 20 percent or more of their assets in this category and all but five credit unions have assets of less than \$10 million. For these credit unions, lowering the rates would threaten their liquidity, capital, earnings, and growth.

The Board has concluded that conditions exist to retain the federal credit union interest rate ceiling of 18 percent per year for the period March 9, 2005 through September 8, 2006. Finally, the Board is prepared to reconsider the 18 percent ceiling at any time during the extension period should changes in economic conditions warrant.

REGULATORY PROCEDURES

Administrative Procedure Act

The Board has determined that notification and public comment on this rule are impractical and not in the public interest. 5 U.S.C. 553(b)(3)(B). Due to the need for a planning period before the March 9, 2005 expiration date of the current rule, and the threat to the safety and soundness of individual credit unions with insufficient flexibility to determine loan rates, final action on the loan rate ceiling is necessary.

Regulatory Flexibility Act

The Regulatory Flexibility Act requires NCUA to prepare an analysis to describe any significant economic impact a regulation may have on a substantial number of small credit unions (those under ten million dollars in assets). This final rule provides added flexibility to all federal credit unions regarding the permissible interest rate that may be used in connection with lending. The NCUA Board has determined and certifies that this rule will not have a significant economic impact on a substantial number of small credit unions.

Paperwork Reduction Act

NCUA has determined that this rule does not increase paperwork requirements under the Paperwork Reduction Act of 1995 and regulations of the Office of Management and Budget.

Executive Order 13132

Executive Order 13132 encourages independent regulatory agencies to consider the impact of their regulatory actions on state and local interest. In adherence to fundamental federalism principles, NCUA, an independent regulatory agency as defined in 44 U.S.C. 3502(5), voluntarily complies with the executive order. This rule applies only to federal credit unions and, thus, will not have substantial direct effects on the states, on the relationship between the national government and the states, nor materially affect state interests. The NCUA has determined that the rule does not constitute a policy that has any federalism implication for purposes of the executive order.

Small Business Regulatory Enforcement Fairness Act

The Small Business Regulatory Enforcement Fairness Act of 1996 (Pub. L. 104-121) provides generally for congressional review of agency rules. A reporting requirement is triggered in instances where NCUA issues a final rule as defined by Section 551 of the Administrative Procedure Act. 5 U.S.C. 551. The Office of Management and Budget has determined that this is not a major rule.

The Treasury and General Government Appropriations Act, 1999 – Assessment of Federal Regulations and Policies on Families

NCUA has determined that this rule will not affect family well-being within the meaning of Section 654 of the Treasury and General Government Appropriations Act, 1999, Pub. L. 105-277, 112 Stat. 2681 (1998).

List of Subjects in 12 CFR Part 701

Credit, Credit unions, Loan interest rates.

By the National Credit Union Administration Board on January 13, 2005.

Mary F. Rupp

Secretary to the Board

Accordingly, NCUA amends 12 CFR chapter VII as follows:

**PART 701- ORGANIZATION AND OPERATION OF FEDERAL CREDIT UNIONS
(AMENDED)**

1. The authority citation for Part 701 continues to read as follows:

Authority: 12 U.S.C. 1752(5), 1755, 1756, 1757, 1759, 1761a, 1761b, 1766, 1767, 1782, 1784, 1787, and 1789. Section 701.6 is also authorized by 15 U.S.C. 3717.

Section 701.31 is also authorized by 15 U.S.C. 1601 et seq., 42 U.S.C. 1981 and 3601-3610. Section 701.35 is also authorized by 42 U.S.C. 4311-4312.

2. Section 701.21(c)(7)(ii)(C) is revised to read as follows:

701.21 Loans to members and lines of credit to members.

* * * * *

(c) * * *

(7) * * *

(ii) * * *

(C) Expiration. After September 8, 2006, or as otherwise ordered by the NCUA Board, the maximum rate on federal credit union extensions of credit to members shall revert to 15 percent per year. Higher rates may, however, be charged, in accordance with paragraph (c)(7)(ii)(A) and (B) of this section, on loans and line of credit balance existing on or before September 8, 2006.

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